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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
P. O. Box 15196
San Diego 15, California

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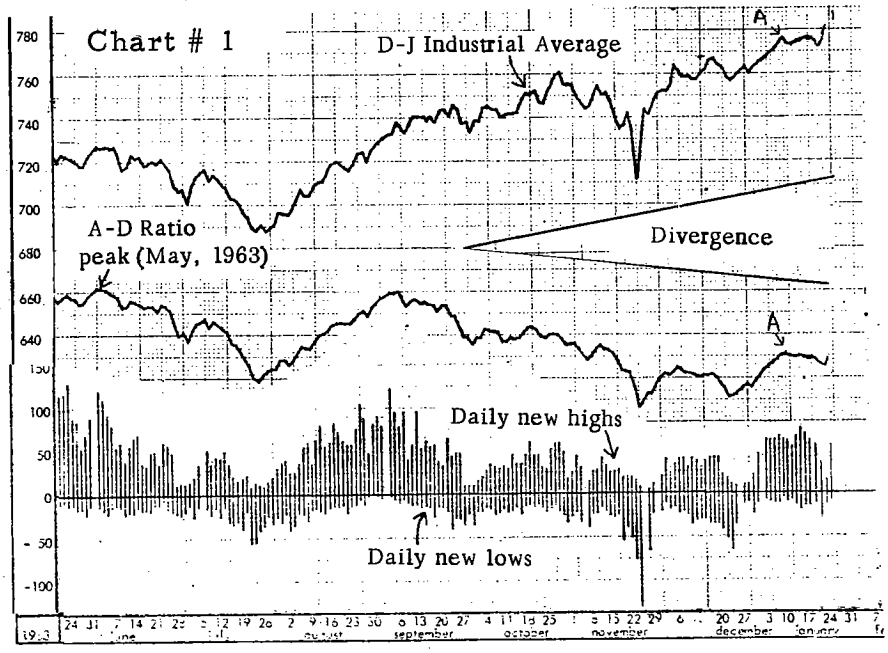
THE MARKET As this Letter is written, the Industrial Average is in the 780-90 level, while Rails are above their 1956 peak of 181.23 and at their highest level since late-1929. The "big picture" as seen on Chart #3 so dwarfs every other market consideration that it is difficult to focus our attention on the intermediate-term action which is represented by Charts 1 and 2. Nevertheless, the near-term details are what makes the big story interesting.

Each new push by the Averages has the effect of widening the "technical vacuum" which has been created by the great strength in the Industrial Average on the one hand — and the persistent weakness in the majority of stocks on the other.

On January 9 (point A on Chart 1) Industrials struck a high of 776.55. New highs that day totaled 58. Following the minor January 9 peak, the A-D ratio retreated while the Averages moved sideways. On January 21, Industrials suddenly spurted to 776.44 — 11¢ under the January 9 high. But the figures for January 21 are most interesting. On that day 53 more stocks declined than advanced and the A-D ratio sank to its lowest level since January 3. Furthermore, against 58 new highs on January 9 (Industrials 776.55), new highs shrank to 23 on January 21 (Industrials 776.44). This is the type of action which (1) makes veteran market practitioners shudder, and (2) makes it so difficult to garner profits in this market.



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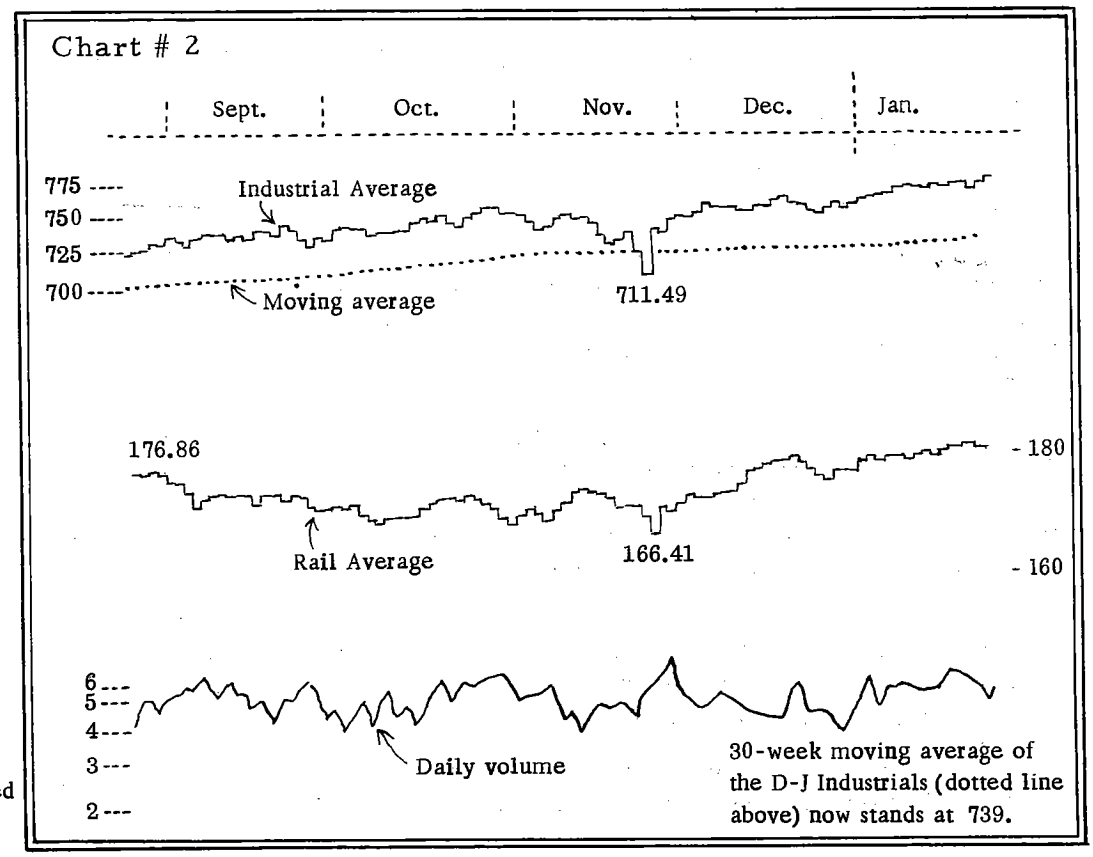
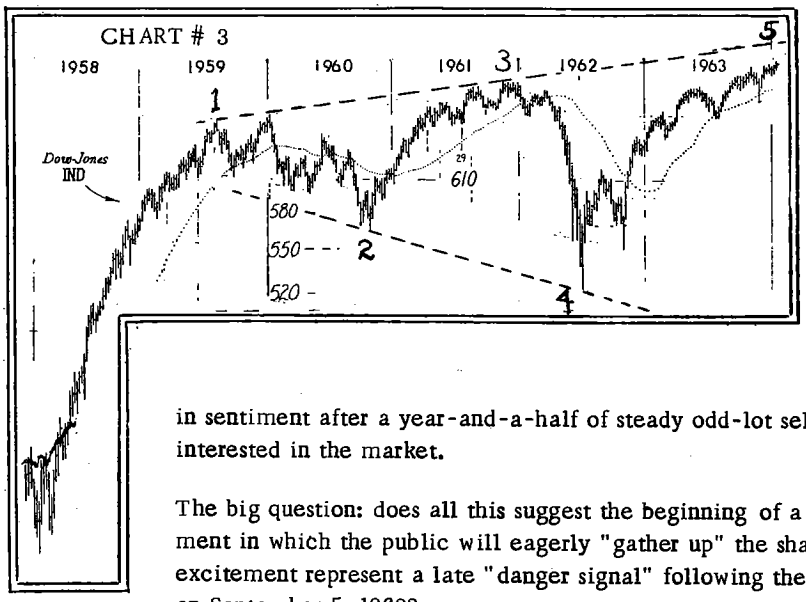
I have expressed the opinion that (1) 1964 will be a year of high excitement in the stock market, and (2) as long as the breadth-price divergence exists, the odds are in favor of the investors losing money in the market. The statistics for the recent week ending January 17 confirm these views so strongly that they are worth examining at this time. Volume for the week ending January 17 totaled 30.4 million shares, which (I believe) represents the highest non-" crash" volume in Stock Exchange history. On a closing basis, Industrials fluctuated during the five trading days within an incredibly narrow range of 3.01 points, ending the week up 1.36. Rails ended up 1.72 points for the week. During the same week, 652 issues advanced





while 670 declined. Thus, while volume fairly exploded and the Averages crept higher, more issues actually declined than advanced. Such action on a weekly basis is extraordinary — it is the very opposite of technical strength.

Other phenomena worth noting: volume on the speculative American Exchange totaled 9 million shares for the week ending January 17; heaviest volume since 1961 (at which time the AMEX was booming). Odd-lot volume as a percentage of total Exchange volume has suddenly spurted to the highest level since January, 1963 (see "Chart of the Week"). Finally, the last few weeks have seen many days of odd-lot buying, and this could represent a switch in sentiment after a year-and-a-half of steady odd-lot selling. My conclusion is that the public is becoming increasingly interested in the market.

The big question: does all this suggest the beginning of a final speculative market surge, a period of frenzied excitement in which the public will eagerly "gather up" the shares held by the professional element? Or does the 1964 excitement represent a late "danger signal" following the extended period of price-breadth divergence which began on September 5, 1963?

Skeptics can point to the fact that the A-D ratio "topped out" eight months ago, and the Industrial Average rarely goes ten months beyond a breadth peak without trouble (see next section). The total short interest dropped dramatically during the latest period (down 1.3 million shares), and this too dilutes the technical position of the market. Finally, the financial news (and predictions) are already so "rosy" that the only surprise would seem to be a forthcoming economic leveling-off or recession — rather than the widely heralded boom.

But in answer the bull can merely turn to Chart 3 of this Letter: "Let the Industrials continue through the upper trendline at point 5 on the chart (approximately 795 on the Dow)," retorts the bull, "and you're liable to see a 'blow-off' that will set the bears' heads spinning." And in the end, it is the market which will have the final say-so; to that extent the bull's are correct even now.

A CRITICAL RELATIONSHIP The trend of the majority of issues on the N.Y.S.E. may be conveniently measured by the advance-decline ratio. During a normal, healthy bull movement the Industrial and Rail Averages rise together and the movements of the two Averages are confirmed by a rise in the majority of Big Board issues (as measured by the A-D ratio). On rare occasions, however, a divergence mars the normal harmonious relationship between the Averages (price) and the A-D ratio (often referred to as breadth). The entire history of the price-breadth relationship shows that when abnormalities between the Averages and the A-D ratio occur, the result is an eventual reversal of the trend which produced the abnormality.

Furthermore, there appears to be a definite sequence which guides the breadth-price reversal. This sequence consists of a "topping out" and decline in the A-D ratio in the face of a continuing rise in the Industrial Average. The history of this reversal action constitutes a fascinating study in technical analysis — a study which has a direct and important bearing on the current market. I have outlined some of that history below.

A major market advance took place during 1953-56. The 1953-56 rise ended for the majority of issues (i.e., the A-D ratio) on March 15, 1956. On that same day the Industrial Average stood at 510. Despite the topping of the A-D ratio, the Averages continued to climb, and on April 6 the Industrial Average established its final peak of 521.05. Thus the senior Average continued to advance for three weeks beyond the date when the A-D ratio turned down. In so doing, the Industrial Average added 2% to its price before it too topped out.

The next major advance occurred during 1957-60. The rise ended for the majority of stocks (the A-D ratio) on March 13, 1959. On that day the Industrial Average stood at 615. Despite the March peak in the A-D ratio, the Industrial Average pushed on to a January 5, 1960, peak of 685.47. Thus, during 1957-60 the Industrial Average was able to extend its rise almost ten months beyond the peak in the A-D ratio. Furthermore, the senior Average at the final January 5, 1960, peak had succeeded in rising 11% beyond the 615 level (615 was the level at which Industrials stood on the day the A-D ratio touched its high).

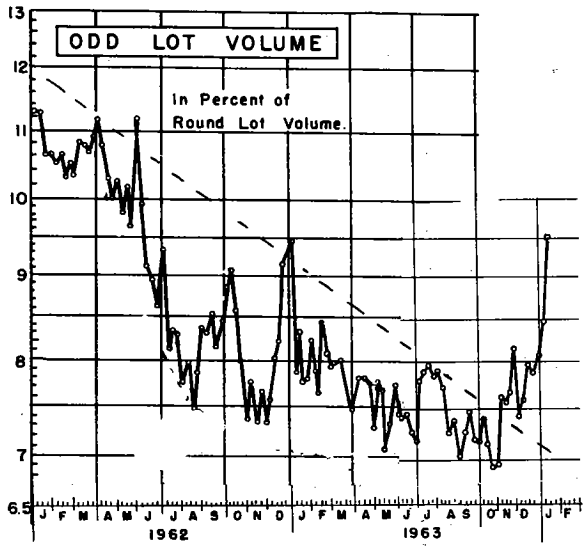
Another important advance came during 1960-61. The 1960-61 advance ended for the A-D ratio on May 17, 1961 — with the Industrial Average at 706. Despite the May peak in the A-D ratio, the Industrial Average climbed to a high of 734.91 on December 13, 1961. All of which meant that the senior Average extended its gains seven months beyond the peak in the A-D ratio, and the percentage of increase in Industrials following the A-D ratio peak was about 11% (the same as 1959).

THE SITUATION TODAY The latest major market advance began in June, 1962. Until proved otherwise, we must consider that the 1962-64 rise ended for the A-D ratio on May 31, 1963. Eight months have elapsed since the 1963 peak in the A-D ratio,

and the two Averages are still pushing into new high ground. The current rise to the 782 level represents an 11% increase in the senior Average since the 1963 peak in the A-D ratio. In other words, the rise to 782 already equals the Industrial performance of 1959 and 1961 and of course betters the performance of 1956.

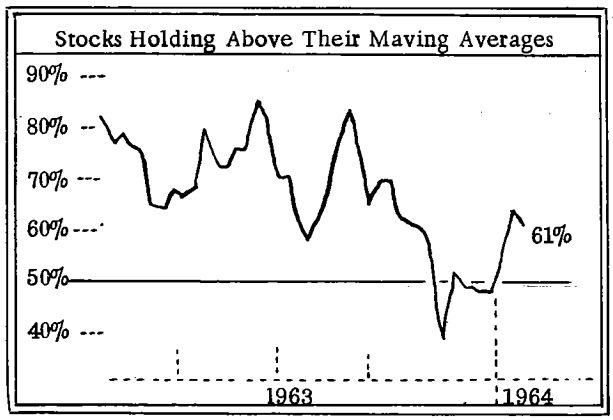
EXCITING PERIOD AHEAD The market should now be at a critical juncture. I list my reasons as follows: (1) The Industrial and Rail Averages are currently "in the clear" — Industrials are at an all-time high and Rails are at their highest level since the 189.11 peak of late-1929. (2) The A-D ratio peak occurred eight months ago. The Industrial Average has seldom extended its rise more than ten months beyond a major peak in the A-D ratio. (3) Industrials are now within a few percentage points of the upper trendline of the great "broadening formation" which has been discussed so frequently in recent Letters (see Chart 3). Thus, the market is getting closer and closer to the time when it must "fish or cut bait". The ability or inability of the Industrial Average to push above the 795-800 level (the upper trendline in Chart 3) constitutes the critical test area ahead.

CHART OF THE WEEK The accompanying chart traces weekly odd-lot volume as a percentage of total Big Board volume. The chart shows that since October, 1963, the odd-lot public has participated in the market to an increasing degree. My own opinion is that we are seeing a definite turn from public apathy to public interest in the stock market.

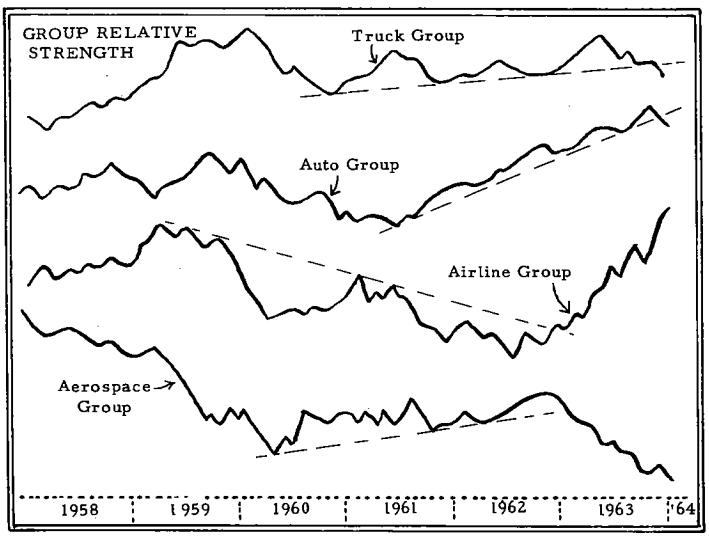


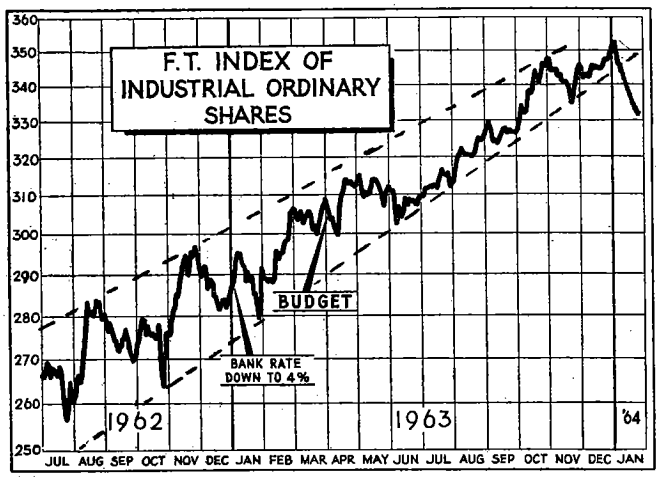
BOOK NOTES Our new book list is ready, and interested subscribers may write for it. New additions; "ABC of Stock Speculation" by S. A. Nelson, containing 17 original Wall Street Journal editorials by Charles Dow. A rare classic reprinted in hard-cover...$5.95. "The Speculator and the Stock Market" by Sloan Wilson. An excellent treatise on the historical aspects of debit (margin) and credit balances in the market. Contains a fine study of speculation during market cycles — 1917 to date. Hard cover...$5.95. We still have historical chart books (daily and weekly) of the Industrials Average and the advance-decline ratio (1931 to date; one page for each year). These are indespensible to market students...$12.50 in loose-leaf binders.

STOCKS Of 432 representative stocks which are tabulated here weekly, 262 (61%) are now holding above their 200-day moving averages. This represents a drop of 5% from last week (see chart at right), but since the bullish percentage is above 50%, this study remains bullish.



Relative Strength (R.S.) measures a stock's performance as compared with the general market. Strongest (or most popular) stock groups continue to be Airlines, Textiles and Drugs — with Business Machines coming up fast. In line with last week's study of Chrysler and GM, note on the long-term R.S. charts below that the Auto Group has now cracked a three-year trend of R.S. This reversal in Auto group action is confirmed by the Truck Group which has also turned down. I continue to feel that motor stocks are a "sale". The Airlines sustained a long decline in popularity between 1959 and 1962. In 1962 the group suddenly turned favorable, and its popularity now surpasses its 1959 peak (I believe Airline popularity is being overdone now). Meanwhile, the companies that make the planes have problems — as seen by the successive new lows in Aerospace R.S. How long the decline in Aerospace popularity will continue, no one knows. These stocks may appear statistically "cheap", but until the market wants them, it will not pay to try to outguess the trend.




F.T. INDEX OF INDUSTRIAL ORDINARY SHARES
BUDGET
BANK RATE DOWN TO 4%
1962
1963
'64
JUL AUG SEP OCT NOV DEC JAN FEB MAR APR MAY JUN JUL AUG SEP OCT NOV DEC JAN

ENGLAND The London market turned up in mid-1962 along with our market. Note that the entire rise was perfectly contained within two ascending and converging trendlines. Such a structure is known as a "rising wedge", and this pattern (often seen in bear market rallies) denotes a situation in which "demand" is slowly being exhausted. Unlike our Industrial Average, the Financial Times's Index failed to better its old high (365 in May, 1961). This month the London Index suddenly dropped out of its wedge. The decline following the breaking of a wedge can be drastic, and the London Average has already broken below its November and December lows. I feel that this situation is particularly worth following, since movements on the London market often precede movements here.

A LETTER received here states: "Dear Mr. Russell, I realize that you do not care for this market, but I recently purchased the following issues based on your page 4 charts: Bucyrus-Erie, Schering, Lowenstein, Int. Nickel. Bucyrus shows me 33% appreciation in a month and the rest (except for Lowenstein) are doing fine. Be bullish or bearish or anything you like, but just keep coming up with good stocks." (S.P., Lexington, Ky.). My answer: More power to you. I still do not believe this is a market for investors. But I realize that many subscribers want to speculate. For those who want to spend their money, I would rather give them a Bucyrus or a Schering than let them buy a Chrysler as it "tops out". So... following are this week's comments.

A WINNER AND A LOSER: The long-term (monthly) chart of Owens-Corning depicts an old "glamour stock" coming back into favor. The three-year decline in OCF's relative strength line has now reversed, and the stock is now turning up in "popularity". It is moving out of a large ascending triangle, a triangle which began forming in 1962. I have noted that when the preceding trend in the R. S. line takes the form of an extended, well-defined channel, the eventual reversal to the new direction is particularly reliable. For this reason I would guess that the new reversal to improving R. S. in OCF will prove to be an excellent omen for the stock. I label this the "prettiest chart of the week".

Less happy is the Chrysler picture (weekly chart below). Chrysler has now cracked its long-term trendline, and this could be the beginning of a collapse in the fantastic "stilt-formation", a formation which made Chrysler the speculative leader during most of 1962-63. It is extraordinary to see this type of weakness in the face of a rising Industrial Average — but this market is giving us a bit of just about everything these days.

In the improving Business Machine group live three little "orphans", Burroughs, Royal McBee and SCM Corp. (the old Smith Corona outfit). All three have collapsed, but two of them (see small charts) now appear to be making the turn to the upside. I list SCM and Royal McBee as two promising low-priced stocks. SCM has been getting violent on the upside, and Royal shows signs of wanting to follow. Burroughs, down from a 1957 high of 52, could be scraping bottom. We'll watch it, but I'm not ready to recommend it yet.

Chart # 1 and chart of Chrysler courtesy of Traders Research, Inc., 1431 Pearl Avenue, Alton, Illinois 62003. Chart of OCF and chart of group relative strength courtesy of Ray * Signals, 141 Broadway, New York City 6, New York. Chart # 3 and charts of RMB, SCM, BGH courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas.